EXECUTIVE SECRETARIAT

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Remarks:

Executive Secretary

2/5/82

Date

3637 (10-81)

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THE WHITE HOUSE
WASHINGTON

Executive Registry
82-0354

CABINET AFFAIRS STAFFING MEMORANDUM

DATE: 2/5/82 NUMBER: 050151CA DUE BY: -----

SUBJECT: CABINET COUNCIL ON ECONOMIC AFFAIRS -- February 8 Meeting

	ACTION	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☐	☑
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☐	☑
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
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	ACTION	FYI
Baker	☑	☐
Deaver	☐	☐
Anderson	☑	☐
Clark	☑	☐
Darman *(For WH Staffing)*	☑	☐
Jenkins	☐	☑
Gray	☐	☑
Beal	☐	☑
Allen Lenz	☑	☐
Larry Kudlow	☑	☐
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CCNRE/Boggs	☐	☐
CCHR/Carleson	☐	☐
CCCT/Kass	☐	☐
CCFA/McClaughry	☐	☐
CCEA/Porter	☑	☐

REMARKS: Attached are the agenda and background papers for the Monday, February 8, meeting of the Cabinet Council on Economic Affairs, scheduled for 8:45 AM in the Roosevelt Room.

TREA has not reviewed. Processed IAW CIA TREA arrangement letter dtd 4/11/08.

RETURN TO: Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

CONTACT: Kenneth Cribb, Jr.
Assistant Director
Office of Cabinet Affairs
456-2800

THE WHITE HOUSE

WASHINGTON

February 4, 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER

SUBJECT: Agenda and Papers for the February 8 Meeting

The agenda and papers for the Monday, February 8 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The first agenda item is the Annual Report of the Council of Economic Advisers to the President. This report is scheduled for release on Wednesday, February 10. A summary, highlighting the important policy conclusions, prepared by the CEA, is attached. This summary should be treated as administratively confidential until the Report is made public.

The second agenda item is a report of the Working Group on LDC Financial Problems. The working group was established last September to examine the financial problems of developing countries, especially problems associated with the rapid growth of LDC debt. A paper summarizing the dimensions of LDC and Eastern European debt, U.S. policies relating to debt relief, and policy issues currently under consideration by the Working Group, is attached. A second paper focusing on the comparability of treatment by public and private creditors in debt relief operations is also attached.

Attachments

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON ECONOMIC AFFAIRS

February 8, 1982

8:45 a.m.

Roosevelt Room

AGENDA

1. Report of the Council of Economic Advisers to the President (CM#198)

2. Report of the Working Group on LDC Financial Problems

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

CM #198

February 2, 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: Murray L. Weidenbaum MW

Subject: Annual Report of the Council of Economic Advisers to the President

Attached is a summary of the CEA's Report to the President, highlighting the important policy conclusions. The Report, along with the President's Economic Report, will be sent to Congress on Wednesday, February 10. The summary should be treated as administratively confidential until Wednesday noon, February 10.

SUMMARY OF THE 1982 CEA REPORT TO THE PRESIDENT

CHAPTER 1 - ECONOMIC POLICY FOR THE 1980s

The first chapter briefly reviews the President's program, economic conditions in 1981, and prospects for recovery in 1982. The chapter makes six important statements which are more fully developed elsewhere in the Report:

1. The speed with which the economy adjusts to the Administration's policies is closely connected with the extent to which individuals believe the Administration will maintain, unchanged, its basic approach to personal and business taxation, Federal spending and regulation, and monetary policy. When public expectations fully adjust to this commitment, a necessary condition for both reduced inflation and higher growth will be fully established. In other words, what some people have referred to as "monetarism" and "supply-side economics" are two sides of the same coin -- compatible and necessary measures to both reduce inflation and increase economic growth.

2. The economy in 1981 reflected the policies of the past and the transitory effects of the necessary changes in those policies. Since the Administration's economic policies are designed to increase long-term economic growth and to reduce inflation, they were not expected to have immediate favorable effects.

The primary redirection of economic policy that affected economic conditions during the year was the reduction in the growth of the money supply from the record high rate of growth in late 1980. Monetary restraint reduced inflation -- and, subsequently, short-term interest rates -- but also influenced the general contour of economic activity in late 1981.

3. Output and employment in 1982 are expected to increase at a moderate rate in the second quarter and at a brisk pace through the rest of the year, probably in excess of a 5 percent annual rate. Inflation is likely to continue to decline and to average about 7 percent for the year, with further progress in 1983 and beyond.

4. Prospective budget deficits reflect the effects of the recession, lower inflation, tax law changes and the need to rebuild our defenses. Although the prospective deficits are undesirably high, they are not expected to jeopardize a revival in business investment, and will show a declining trend.

5. Concerns that the Federal Reserve's targets for money growth are not compatible with the vigorous upturn in economic activity envisioned later in 1982 are unjustified. Fears that the upturn will lead to a sharp upswing in interest rates and choke off recovery, while understandable on the basis of previous history and policies, are unjustified in light of current policies and the Administration's determination to carry them through.

Interest rates, after more than a decade of rising inflationary pressures, still contain sizable premiums to compensate lenders for the anticipated loss in value of future repayments of principal. Those premiums will continue to decline throughout 1982 and beyond, even while "real" (inflation-adjusted) interest rates remain high as a result of private and public sector credit demands. Thus, market rates of interest are likely to continue trending downward, even though short-run fluctuations in the trend can be expected. A critical assumption is that inflationary expectations will, in fact, continue to recede. If they fall at a relatively fast rate, market rates of interest will decline significantly, wage demands will continue to moderate, and the pro-inflationary biases that have developed throughout the economy over the past decade will quickly disappear.

6. Thus, the greater the degree of cooperation between the Administration, the Congress, and the Federal Reserve in continuing to support a consistent, credible anti-inflation policy, as embodied in the Administration's program, the more rapidly will real growth and employment increase.

CHAPTER 2 - GOVERNMENT AND THE ECONOMY

This chapter begins by discussing links between political freedom and economic freedom. It analyzes the economic rationale for government intervention and discusses the arguments for limits on the Federal role in the economy Federalism is explored as a way to achieve both greater efficiency in the provision of public services and greater individual freedom and choice.

The chapter concludes with a discussion of the principles guiding the President's program: emphasis on personal responsibility, reform of regulation, strengthened federalism, the need for a long-run focus, and increased reliance on the market.

CHAPTER 3 - MONETARY POLICY, INFLATION AND EMPLOYMENT

Chapter 3 begins with a discussion of the "legacies of the past" (the belief in fine-tuning the economy, stagflation, and the trend of rising inflation). After explaining the nature of the inflation process, the costs and benefits of reducing inflation are examined with particular attention to how those adjustment costs can be reduced by making policy consistent and credible.

The chapter also examines monetary policy and reviews Federal Reserve operating procedures. A short discussion of the gold standard examines the extent to which price and output levels were stable during the 19th century. The chapter concludes with a discussion of the nature of a monetary rule and the importance to the world economy of the United States bringing inflation fully under control.

CHAPTER 4 - FEDERAL BUDGET ISSUES

This chapter reviews many of the key implications of the FY 1983 Budget, showing how they relate to the appropriate role of the Federal Government developed in Chapter 2.

The chapter discusses the implications of the defense build-up for the economy along the lines of papers previously presented to the CCEA and the Joint Economic Committee. It concludes with a discussion of why Federal deficits matter, touching on their economic and financial market impacts, private sector expectations, effects, impact on long-run economic growth, and role in maintaining budget discipline.

CHAPTER 5 - TAX POLICY AND ECONOMIC GROWTH

This chapter reviews in detail many of the economic implications of the Economic Recovery Tax Act of 1981. It begins with a discussion of recent trends in economic growth and the economy's future potential, and reviews our knowledge (or lack of it) about declining productivity growth. A discussion of the economic effects of tax policy includes an examination of changes in effective personal and business tax rates through 1986. The chapter also shows how overly rapid expansion of the money supply can act as a tax.

CHAPTER 6 - REFORMING GOVERNMENT REGULATION OF ECONOMIC ACTIVITY

The chapter reviews the growth of Federal regulation and the Administration's program for regulatory relief. Pollution control and health care are analyzed as examples of how market-oriented approaches to certain problem areas can be preferable to detailed regulation. The chapter then reviews regulatory questions in selected areas, including financial institutions, agriculture, and telecommunications.

CHAPTER 7 - THE UNITED STATES IN THE INTERNATIONAL ECONOMY

This chapter covers three areas important to U.S. international economic policy: the role of the dollar in the international monetary system, the increased importance of international trade and finance for the U.S. economy, and the evolving role of international institutions in promoting a more open economic environment.

The chapter emphasizes how sound economic policies at home can lead to an expanded role for the dollar in world trade and finance and a more stable international monetary system. It also explains the basis for our policy of non-intervention in foreign exchange markets.

CHAPTER 8 - REVIEW AND OUTLOOK

The final chapter of the Report covers in more detail the points summarized in Chapter 1 - the extent to which economic developments in 1981 reflected the policies of the past and the necessary corrections to them, and the basis for anticipating strong recovery in the second half of 1982.

The chapter reviews employment developments during 1981. It concludes with a discussion, as required by law, of important economic trends out to 1987.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

FEB 04 1982

CM-179

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: MARC E. LELAND
ASSISTANT SECRETARY
INTERNATIONAL AFFAIRS

ERNEST B. JOHNSTON EBE for
ACTING ASSISTANT SECRETARY
ECONOMIC AND BUSINESS AFFAIRS
DEPARTMENT OF STATE

SUBJECT: Debt Problems of LDCs and East European Countries

A Working Group of the CCEA was established last September to examine the financial problems of developing countries -- especially the rapid growth of LDC debt. At the Group's first meeting, it was agreed to extend the scope of the Group's work to the debt situation in East Europe.

The Working Group has completed an initial survey of the LDC and East European debt situations, and of relevant U.S.G. policies and procedures. Highlights of this survey are summarized in the following sections.

The Dimensions of LDC Debt

The total external debt of 143 LDCs amounted to $489 billion at the end of 1979. Four-fifths of the total was long-term debt. The external debt of the non-oil LDCs grew at an average annual rate of 22% during the 1970s -- or 6-9% after adjusting for inflation. The growth of debt is estimated to have been somewhat slower in 1980 and 1981.

Debt service payments for the non-oil LDCs grew more rapidly (28% nominal) during the decade, reflecting a shift toward borrowing from private lenders that entailed shorter maturities and higher interest rates. The aggregate ratio of debt service to exports rose from 16% in 1970 to 19% in 1979. However, the ratio of debt outstanding to exports declined from 126% to 109%.

LDC debt is highly concentrated among a small group of LDCs which are either oil exporters or major exporters of manufactures. Ten countries account for 50% of the long-term debt of all 143 LDCs. These are Brazil, Mexico, Algeria, India, Indonesia, Korea, Yugoslavia, Argentina, Egypt and Turkey.

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Controlled by M.E.Leland
Date 4 February 1982

The Dimensions of East European Debt

The total external debt of the USSR and five other East European countries rose from $11 billion at the beginning of the 1970s to roughly $81 billion at the end of 1980 (22% per annum). Three countries -- Poland, the USSR and the GDR -- account for two-thirds of the total.

After Poland, the countries with the weakest debt-servicing capacity are Romania and Yugoslavia (a non-Soviet bloc country). Romania has recently taken initial steps to obtain debt relief from official and private creditors. Yugoslavia might have to resort to debt relief if its access to private capital markets is seriously affected either because of reluctance on the part of private lenders to lend to East Europe generally (due to the Poland situation), or because of further delays in improving its economic performance.

In general, their desire to maintain access to western capital is expected to force the East European countries in the next few years to cut back on investment, consumption, or both, in order to maintain or strengthen their creditworthiness.

Debt Servicing Difficulties

Three degrees of debt-servicing difficulties can be distinguished: mild, serious and critical. Critical difficulties are indicated by the country's decision to seek debt relief.

An IMF analysis of the causes of debt-servicing difficulties included several notable points: (a) the difficulties evolved over a period of several years; (b) the single most important cause was the adverse impact of fiscal and monetary imbalances on the external sector, especially through rapid import growth; and (c) the imbalances were often related to ambitious development plans or social/political pressures. (There is evidence that another important cause was political instability. Soaring oil prices have also had an important impact, of course.)

Policies and Procedures

Since World War II the international community has developed relatively effective ad hoc procedures for assisting countries experiencing debt-servicing difficulties. The IMF plays a central role in these procedures. The procedures followed by official creditors, as embodied in the "Paris Club", are more standard and more formal than those followed by private creditors (especially commercial banks). For a variety of reasons, typical terms for official debt-relief arrangements are consistently different from those for private arrangements.

U.S. policies on extending debt relief to foreign countries spring from the broad responsibilities of the Executive Branch and from the legislation establishing specific foreign credit programs.

In a 1970 opinion, the Attorney General concluded that the Executive Branch has considerable flexibility in modifying loan repayment terms, especially when the borrowing country is in a situation of default or imminent default. There is substantial Congressional interest in U.S. debt policy which is reflected in provisions of several authorization and appropriations acts.

Since 1970, the USG has adopted relatively rigorous procedures for identifying and eliminating delinquent payments. There is a formal reporting system that supports these procedures. The principal interagency body concerned with these procedures is the National Advisory Council (NAC) on International Monetary and Financial Policies.

In 1978, the NAC adopted a statement of U.S. policy on debt reorganization. The Treasury Department and the State Department have a joint responsibility for USG participation in debt-relief negotiations --in collaboration with the creditor agencies concerned.

U.S. Exposure

U.S. Government exposure in the LDCs at the end of 1980 amounted to $40 billion associated with direct credits and $13 billion with guaranteed credits. USG exposure on direct credits is heaviest in Israel, Egypt, India, Korea, Pakistan, Brazil, and Indonesia. (All over $2 billion.)

Arrearages on all post-WWI USG foreign credits at the end of 1980 were close to $1 billion, but 83% of these were "extraordinary political arrearages" (Cuba, Iran, Vietnam, etc.). The budgetary impact of the shortfalls resulting from debt-relief agreements is significant. For FY 1981, these shortfalls have been estimated at around $700 million (including $285 million for Poland).

The exposure of U.S. banks in non-oil LDCs at the end of 1980 was $111 billion. Just four countries (Mexico, Brazil, Korea and Argentina) accounted for 50% of U.S. bank exposure. Sixty percent of the banks' claims on non-oil LDCs had a remaining maturity of one year or less.

Initial Policy Issue

Among the major policy issues that have surfaced so far, the Group concluded that the first issue to raise with the CCEA should be the issue of "comparable treatment" of private and official creditors in debt-rescheduling operations.

USG policy seeks to ensure that debt-relief extended by the USG does not serve to "bail out" private creditors. However, some U.S. bankers have argued that this policy of "comparable treatment" is unfair and conflicts with the USG policy of non-interference in the commercial decisions of private banks. The Working Group has examined the economic arguments for and against comparable treatment, and has considered the possibility of defining comparable treatment more precisely. The group has also considered the application of current policy in the specific cases of Poland, Romania, Sudan and Zaire in recent months.

The Group has concluded that: (a) current policy on comparable treatment should be maintained; (b) the vagueness of the term "comparable treatment" provides needed flexibility in the application of U.S. policy; (c) USG policy on non-interference in the commercial decisions of private banks encompasses decisions on debt relief; and (d) in specific cases where innovative approaches to debt relief may be justified, comparable treatment should remain as an objective.

A separate memo on comparable treatment accompanies this one.

Other Policy Issues

A. Official Credits

1. USG agencies have repeatedly extended or guaranteed new loans to countries with significant external arrears. Other governments have behaved similarly. Often, financial concerns are overridden by political interests abroad or by domestic pressures to promote exports. Sometimes such lending can exacerbate debt-servicing difficulties, thereby undermining the political or export objectives in the long run. Are there new policies or financing techniques that would avoid the pitfalls of the current practices?

2. The conventional "Paris Club" and "London Club" approach to debt relief has been effective in many cases. Recently, however, the results have been unsatisfactory in countries that have had "prolonged" debt problems, such as Sudan, Turkey and Zaire. Are there alternatives to rescheduling (e.g., moratoria and special balance of payments loans) or unconventional approaches to rescheduling that should be considered in special cases?

3. Eximbank and OPIC have sought "preferred creditor status" in debt rescheduling situations -- by establishing off-shore escrow accounts, for example. In addition, USG lending agencies have recently adopted a more market-oriented basis for charging interest on their rescheduled loans. This has created some inconsistencies between agencies. Also, it substantially reduces the value of the debt-relief provided. Are modifications called for in the present practices of USG lending agencies regarding debt-relief?

B. Private-Sector Credits

Relationships between governments and commercial banks vary from country to country, and appear to have an important bearing on how creditor countries respond to requests for debt relief. This factor may have contributed to difficulties in arriving at a consensus among creditors on the timing, form and terms of debt relief in specific cases -- and on the provision of new credits. Are there steps the USG can take to encourage other governments to adopt more market-oriented and financially sound approaches to debt relief and to the extension of new credits to countries experiencing serious debt-servicing difficulties?

C. The Roles of the International Institutions

1. The MDBs have been exempt from participation in multilateral rescheduling operations. There are a number of countries, however, whose debt service obligations to the MDBs have recently become quite large. If one of these countries were to seek debt relief, the MDBs might have to provide such relief. In addition, the proposals for new instruments to encourage more cofinancing by commercial banks with MDBs raise questions about the treatment of both bank and MDB loans when the borrower seeks debt relief. If debt relief is sought from creditor MDBs, should the USG consider changing its policy of supporting the exemption of MDBs from multilateral rescheduling operations? How do the evolving proposals for MDB co-financing impact on MDB and commercial bank participation in debt rescheduling?

2. In some recent cases, it appears that incomplete information on a country's external debt obligations has been an obstacle to formulating sensible policies on new lending or debt relief. The IMF, the IBRD and the BIS are the principle sources of information on international debt. Are there steps the USG and other creditors can take to improve the information base on international debt?

3. The USG has been pressed to participate in debt-relief negotiations before the debtor countries have concluded an arrangement with the IMF. Also, a second or third year of debt relief has been extended to countries even when they were not in compliance with their IMF arrangement. Should the USG continue to condition its participation in multilateral debt-relief negotiations on prior IMF Executive Board approval of a standby arrangement with the debtor country? What alternatives exist to multi-year debt-relief arrangements linked to compliance with an IMF arrangement?

D. East European Debt

Assessments of the debt-servicing capacity of East European countries are greatly complicated by the unusual trade and payments arrangements among these countries. Strong countries within the Bloc can "bail out" weak countries in ways that are difficult to identify. The requests for debt relief from Poland, Romania and Yugoslavia pose other unusual problems for official and private creditors. What steps can the USG take to ensure that the risks of lending to East European countries are properly assessed? Are special approaches necessary for dealing effectively with the debt-servicing difficulties of East European countries?

Controlled by M.E.Leland
Date 4 February 1982

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DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

CM-179

FEB 04 1982

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: MARC E. LELAND
ASSISTANT SECRETARY
INTERNATIONAL AFFAIRS

ERNEST B. JOHNSTON EBJr
ACTING ASSISTANT SECRETARY
ECONOMIC AND BUSINESS AFFAIRS
DEPARTMENT OF STATE

SUBJECT: U.S. Debt Policy -- The Role of Comparable Treatment

Issue

U.S. policy seeks to ensure that debt relief granted by the USG does not serve to "bail out" private creditors. However, some U.S. bankers have argued that this policy of "comparable treatment" is unfair and conflicts with the USG policy of non-interference in the commercial decisions of private banks.

Should our current policy on comparable treatment be maintained? Should it be defined more precisely?

Background

As far back as the 1968 debt-relief negotiations with Peru, the principle of comparable treatment for official and private creditors has been incorporated in the multilateral debt-relief agreements negotiated by official creditors. The standard language contains a commitment by the debtor country to "seek to secure from other external creditors, including banks, rescheduling ... arrangements on terms comparable to those ..." obtained from official creditors.

U.S. policy on comparable treatment was not formalized until 1978 when the National Advisory Council adopted a statement of policy on debt reorganization (attached). The event precipitating the statement was Congressional action authorizing U.S. participation in the IMF's Supplementary Financing Facility. Specifically, Congressman Cavanaugh charged that the Executive Branch was prone to use debt relief to "bail out" commercial banks that had made imprudent loans to developing countries. The Administration responded that existing policies were designed

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Date 4 February 1982

to avoid actions of this nature, and transmitted to the Congress the text of the National Advisory Council Action. [1]

The earliest case when comparable treatment arose as a serious issue occurred in connection with a series of Paris Club negotiations with Zaire in 1976-79. Commercial bank exposure in Zaire was around $500 million, and yet the banks (led by Citibank) argued vehemently that they should not be required to extend debt relief to Zaire. By 1979, the official creditors took a firm position that they would not provide further debt relief to Zaire without "comparable" action by the banks. In late 1979, a debt-relief agreement with the banks was concluded, and a new Paris Club meeting was held shortly thereafter.

By contrast, a high degree of comparable treatment was achieved in the 1978 debt relief negotiations with Peru. The commercial banks set the pace by concluding a refinancing agreement covering 90 percent of the principal payments falling due in 1979 and 1980. These amounts were to be repaid in seven years including a three-year grace period. Subsequently, official creditors concluded a debt relief agreement with Peru on virtually the same terms.

More recently, the U.S. had some concerns about comparable treatment in the official debt relief negotiations with Turkey in 1980. Treasury prepared a limited quantitative analysis of the debt-relief arrangement proposed for official creditors to determine what amount of refinancing or new lending by commercial banks would be necessary to achieve comparability. Assuming the ratio of exposure before and after debt relief should be the same for both categories of creditor, the analysis concluded that an increase in bank exposure of around $350 million, over existing exposure of $6.5 billion, would be necessary. However, other equally valid approaches would have yielded different conclusions. The lesson drawn from this experience was that there is no single quantitative test of the comparability of private and official debt relief arrangments.

Discussion

1. Economic Arguments For and Against Comparable Treatment

There are two economic arguments underlying the principle of comparable treatment. First of all, when a country experiences a shortage of foreign exchange that prevents it from meeting all its obligations to external creditors, it should allocate the available foreign exchange among creditors in an equitable

[1] Ultimately an amendment was added to the IMF legislation requiring the Secretary of the Treasury to instruct the U.S. Executive Director in the IMF to seek to assure that no decision on use of IMF resources undermines U.S. policy making regarding comparability in debt rescheduling where official U.S. credits are involved.

or nondiscriminatory fashion. To favor one category of creditor over another could lead aggrieved creditors to withhold further financial support, or to seize assets, which would undermine the country's efforts to re-establish its creditworthiness. (At present, the only creditors for which preferential access to scarce foreign exchange is sanctioned are the multilateral development banks. This exception is implicit in multilateral debt-relief arrangements and has been considered to be in the mutual interest of both private and official creditors.)

The second argument is that, if official creditors eliminate risk from international lending by commercial lenders, then financial resources channeled through these lenders may be misallocated. Debt relief extended to a country by official creditors without comparable relief from private creditors would have the effect of reducing risk. It is this argument that is reflected in the Congressional concern with "bailing out" commercial banks.

There are two economic arguments against comparable treatment. They were both advanced by Citibank in seeking preferred status for commercial banks that had exposure in Zaire in the 1976-79 period. One argument is that banks are in the business of "serious" lending in contrast to governments that make loans for a variety of political, economic and humanitarian reasons. Thus, debt-service obligations to commercial banks (and other private lenders) should be met before obligations to governments when there is a foreign-exchange shortage. The other argument is a practical one. If banks are given preferred status, it is contended, they will continue to lend to a country experiencing payment difficulties (or a particular borrower that plays a key role in the economy) -- and this will enable the country to resume paying its official creditors on schedule sooner. There are obvious rebuttals to both arguments.

It is also worth pointing out that banks in a number of cases have provided debt-relief even though official creditors have not provided such relief -- most recently to Bolivia and Jamaica. In other words, our policy on comparable treatment is not symmetrical -- and deliberately so.

2. Defining Comparable Treatment

Even if the principle of comparable treatment is accepted, questions remain regarding what constitutes comparable treatment and whether the U.S. government should establish standards for comparable treatment.

In composing the 1978 statement of U.S. policy, various formulations were considered. In the end, there was interagency agreement that the vague phrase "comparable treatment" was the best. However, the following explanation was included in a background section accompanying the policy statement that was transmitted to the Congress:

> Comparability can be achieved without actually rescheduling or refinancing debt-service payments, if the private creditors agree to extend additional credits (i.e., greater than the amount which would have been rescheduled or refinanced if they had chosen those methods of debt reorganization) to the debtor country on terms comparable to those negotiated in the [official] creditor club.

The point of the explanatory language is that debt relief can take many forms, and that the U.S. policy on comparability does not require private creditors to extend relief in any particular form. In practice, there are four main elements to comparability: the consolidation period, repayment period, amounts, and the treatment of interest. (A basic feature of debt relief arrangements is that there are trade-offs among the different elements.)

Sometimes commercial banks provide debt relief by restructuring the entire stock of their outstanding debt, or a portion of it. Official creditors have never done this because their debt is predominantly long-term debt with final maturities as far as 50 years in the future. Therefore they reschedule payments on their debt falling due during a relatively short period, usually one year, referred to as the consolidation period. When commercial banks also use a consolidation period approach, then a congruence of consolidation periods would be necessary to achieve comparability *ceteris paribus*.

The repayment period for rescheduled debt usually includes a grace period. In recent operations, the longest grace period offered by official creditors has been five years, and the longest repayment period (including grace years) has been 11 1/2 years. To be comparable, grace and repayment periods in official and private debt-relief arrangements need to be quite close, *ceteris paribus*.

The amounts of relief are determined by the consolidation period, and the percentage of payments subject to consolidation. (Typically 80-90 percent of the payments fallng due are rescheduled, with the 10-20 percent remaining to be paid according to the original schedules.) Amounts must be considered separately because exposure levels can be very different prior to debt relief and because new lending can substitute for rescheduling or refinancing. For example, if commercial bank exposure is twice as large as government exposure, then the banks would need to provide roughly twice as much relief *ceteris paribus* to ensure comparability. In another case, governments might provide substantial amounts of new credits in addition to debt relief. If private creditors are reducing their exposure in the country at the same time, governments could be criticised for "bailing out" the private creditors.

The treatment of interest in debt relief arrangements is by far the thorniest aspect of comparability. On the official side, there has been a willingness to reschedule interest as well as principal payments in most cases. In addition, the practice of official creditors is to charge concessional interest rates on debt relief provided for concessional loans and market-related rates on relief provided for export credits and other non-concessional loans.

On the private side, however, there has been great reluctance to capitalize interest payments, or provide relief with respect to these payments in any other form. This reluctance obviously stems from the desire to avoid, in effect, transforming interest due into ever-mounting non-performing assets that would be critically appraised by internal or external auditors. Such a situation might require that earnings be placed on a cash rather than an accrual basis and/or that additional loan loss reserves be lodged -- both of which would reduce the banks' reported income. Beyond this, there also seems to be a sense among bankers and bank regulators alike that providing debt relief on interest payments is fundamentally wrong.

Acknowledging the validity of the bankers' views, government creditors have not insisted that interest be rescheduled in order to achieve comparability. In fact, there are only two cases (Nicaragua in 1980 and Sudan in 1981) where relief on interest payments was an integral part of a debt-relief agreement involving commercial banks.

The issue is particularly significant when interest rates are high. On the one hand, the interest portion of debt service due is much higher and excluding interest due to private creditors could significantly decrease the scope for debt relief. Moreover, in the inflationary periods that produce high nominal interest rates, interest payments entail in real terms a significant amount of principal repayment (although bankers are probably unimpressed by this thesis). On the other hand, banks have to fund any new asset, including capitalization of interest, at rates that are nearly as high as lending rates, and thus stand to lose a good deal more if they are unable to take accrued interest into income.

The commercial banks have sensed some pressure from governments (and from the IMF and the IBRD) to be "more generous" in their debt relief arrangements. In response, some bankers have sought a clearer definition of comparable treatment. They would like a more explicit understanding that banks are not expected to duplicate Paris Club terms, and particularly not to reschedule interest due.

From the U.S. Government's point of view, the major difficulty with providing a clearer definition of comparability is that there is no satisfactory methodological or conceptual basis for doing so. Since every debt-relief case is different, there is much to be said for a case-by-case approach based on the kind of general principles included in the 1978 policy statement. It is easy, for example, to conjure up a case where political/strategic interests on the part of governments argue for very generous debt relief terms (a la Indonesia in 1970) that would be entirely inappropriate for banks. It is equally easy to imagine a case where the country is so broke that banks have no alternative to charging off the loans other than rescheduling interest payments (a la Nicaragua). Whatever the circumstances, however, U.S. Government policy is to avoid intervening in banks' commercial judgments (as distinct from pointing out the potential consequences of various courses of action and from routine exchanges of view on the economic and political prospects of particular countries). In short, there is a certain contradiction between non-intervention in the lending decisions of banks and taking any action aimed at achieving comparable treatment.

3. Appropriate Terms in Prolonged Cases

The procedures that the international financial community follows for assisting countries experiencing critical debt-servicing difficulties have evolved over the last 25 years. These procedures have worked satisfactorily except in several cases of "prolonged debt crisis". In chronological order, these are the cases of Zaire (1976), Turkey (1978), and Sudan (1979). There is some evidence that the debt relief provided in each case by official and private creditors has helped to prolong the crisis. On the official side, repayment terms were set in early negotiations that had to be revised in subsequent negotiations (through rescheduling of "previously rescheduled debt"). On the private side, the very high interest rates recently prevailing in international capital markets that are applied to the relief offered by banks have represented a heavy claim on the countries' scarce foreign exchange resources, making it more difficult for the countries to restore the productive capacity of their economies.

In the next 3-4 months, the U.S. Government faces difficult negotiations with both Sudan and Zaire. In the context of each of these cases, it will be necessary to examine innovative approaches to official debt relief that will be more effective in helping these countries re-establish their creditworthiness. Innovation on the official side, if not matched by innovation on the private side, however, may raise comparable treatment as a public issue.

Recommendations

The Working Group recommends that the Cabinet Council adopt the following four policy guidelines:

1. Comparable treatment between private and official creditors should continue to be an important element of U.S. policy on the extension of debt relief to foreign countries.

2. The vagueness of the term "comparable treatment" reflects the fact that USG policy aims toward "comparable" but not necessarily "identical" treatment for official and private creditors. In any particular case, the objectives and constraints for official and private creditors may properly differ. Thus the term "comparable treatment" allows for needed flexibility in the application of U.S. policy.

3. Comparable treatment does not necessarily require that commercial banks provide relief on interest payments when governments do so, although under some circumstances new credits might be the only alternative. The policy of the U.S. Government not to become involved in the commercial judgments of private banks extends to decisions on debt relief.

4. Innovative approaches by official creditors for dealing with "prolonged debt crises" may be necessary. Comparable treatment may pose difficulties for innovations in these cases, but it should remain as an objective.

Attachment

Controlled by M.E.Leland
Date 4 February 1982

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FOR NAC USE ONLY

Action 78-5
January 6, 1978

National Advisory Council
On International Monetary and Financial Policies

Subject: Proposed Policy Statement on Debt Reorganization

Action:

The National Advisory Council advises the Secretary of the Treasury that it approves the following proposed policy statement on multilateral debt reorganizations:

1. Debt-service payments on international debt should be reorganized on a case-by-case basis only in extraordinary circumstances where reorganization is necessary to ensure repayment. Debt relief should not be given as a form of development assistance.

2. Debt-service payments on loans extended or guaranteed by the U.S. Government will normally only be reorganized in the framework of a multilateral creditor-club agreement.

3. When a reorganization takes place that involves government credits or government-guaranteed credits, the U.S. will participate only if:

(a) the reorganization agreement incorporates the principle of non-discrimination among creditor countries, including those that are not party to the agreement;

(b) the debtor country agrees to make all reasonable efforts to reorganize unguaranteed private credits falling due in the period of the reorganization on terms comparable to those covering government or government-guaranteed credits;

(c) the debtor country agrees to implement an economic program designed to respond to the underlying conditions and to overcome the deficiencies which led to the need for reorganizing debt-service payments.

4. The amounts of principal and interest to be reorganized should be agreed upon only after a thorough analysis of the economic situation and the balance-of-payments prospects of the debtor country.

(Continued)

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(Continued)

5. The payments that are reorganized normally should be limited to payments in arrears and payments falling due not more than one year following the reorganizing negotiations.

The foregoing is the text of an action of the National Advisory Council on International Monetary and Financial Policies approved on January 6, 1978.

Robert S. Watson

Robert S. Watson
Secretary

References:
NAC Document 78-1

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